California State Senate

COMMITTEE
ON
BUDGET AND FISCAL REVIEW

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Agenda

Senate Budget and Fiscal Review Committee
Senator Wesley Chesbro, Chair

March 2, 2006
Room 112 - 9:30 a.m.

SCA 21 – Runner – Constitutional Limit on State's Bonded Indebtedness

SENATE COMMITTEE ON BUDGET AND FISCAL REVIEW
Wesley Chesbro, Chair

Bill No:	**SCA 21**
Author:	**Runner**
As Amended:	**January 11, 2006**
Consultant:	**Dave O'Toole / Daniel Alvarez**
Fiscal:	**Yes**
Hearing Date:	**March 2, 2006**

SUBJECT

Constitutional Limit on State's Bonded Indebtedness

DESCRIPTION

This proposed constitutional amendment would place a 6 percent restriction (or cap) on the amount the state would spend for infrastructure debt service each year relative to the state's General Fund revenue.

Specifically, this Constitutional Amendment:

1) Limits annual appropriations on principal and interest on General Fund-supported bond debt to no more than 6 percent of General Fund revenues, estimated over a five year period, beginning with the budget year.

2) Includes in the 6 percent cap limit, as necessary, any continuous appropriations that are to be funded or refunded from the proceeds of General Fund-supported debt and have not been encumbered. In addition, specifies that General Fund debt obligations include General Fund appropriations that are allocated to make lease payments for lease revenue bonds.

3) Requires the Governor's Budget to contain separate aggregate estimates of General Fund revenues and expenditures for General Fund-supported debt over the ensuing fiscal year and four years following.

4) Requires the Director of Finance (DOF), during the month of May, to provide an estimate of General Fund revenues, and principal and interest payments payable on General Fund supported debt for the ensuing fiscal year and four years following.

5) Prohibits the Legislature from sending to the Governor, and the Governor from signing, a budget bill that exceeds the 6 percent debt service ratio requirement as calculated by the DOF.

Existing Provisions of the State Constitution Related to State Indebtedness

The State Constitution prohibits the Legislature from creating any debt in excess of $300,000, unless authorized by law and submitted for a vote of the people and receiving a majority of all votes cast. In addition, the State Constitution states that nothing shall be construed to impair the ability of the State to meet its obligations with respect to existing or future bonded indebtedness.

FISCAL EFFECT

1) Unknown effect on state bond-funded projects by creating uncertainty over what projects would be sacrificed in order to ensure bond expenditures do not annually exceed 6 percent of General Fund expenditures.

2) Minor annual General Fund costs, likely less than $75,000, for the Department of Finance to provide the separate five-year aggregate estimate of General Fund revenues, and principal and interest costs.

COMMENTS

1) ***Intent.*** According to information provided by the author, "The 6 percent limit reflects a generally accepted prudent level of state debt. While bond rating agencies might accept a higher level, the administration chose the more conservative standard."

2) ***No Hard Rule on Level of Bonded Indebtedness.*** According to the Legislative Analyst's Office (LAO), there is no accepted rule for how much debt is "too much" or how many bonds the state can "afford." Rather, the appropriate level of bonded indebtedness is a policy choice regarding identity and level of revenue sources (General Fund or special fund fees), as well as market conditions at the time of sale. LAO indicates that under certain circumstances, a debt-service cap could interfere with the state achieving an optimal mix of infrastructure versus other types of spending, or could encourage the use of non-optimal bond maturity structures simply in order to circumvent the cap. In such cases, a cap would not be in the public interest.

   According to the State Treasurer, the debt service ratio is only one factor of many that is used to evaluate the appropriate level of debt. In the past, Wall Street rating agencies compared the debt levels of different states by computing the ratio of debt service to revenues. But the rating agencies stopped publishing this comparison in 1997. The rating agencies look at a variety of measures, especially whether states have a truly balanced budget.

3) ***Cap will restrict policy choices for future infrastructure spending.*** Largely as a result of the debt service cap, the administration and Legislature could be constrained from investing more heavily in infrastructure improvements, should the need or desire

arise. By limiting annual General Fund payments for General Obligation (GO) bonds to no more than 6 percent, coupled with the level of GO bonds contemplated by the administration ($68 billion over ten years) – the state would tie up bond priorities for the next 10 years. Given ever changing priorities and dynamics, it is difficult to say that the priorities and needs identified today will be the same 10 or even 5 years from now.

4) ***Debt Service Ratio***. Debt service is the cost of interest, principal, and fees on existing and proposed new bonds. The debt service ratio is defined as the ratio of annual debt service costs to yearly revenues. Some states exceed the 6 percent limit and still have a higher credit rating than California.

5) ***No State Infrastructure Plan from the Administration.*** Current law requires that the Governor submit annually in January a state infrastructure plan. For various reasons, no plan was prepared for either 2004 or 2005. According to the Department of Finance, the required 2006 plan will not be available until March 2006. Without the plan, the Legislature cannot gauge whether the administration's project priorities correspond with its own.

6) ***Administration's Infrastructure Plan.*** SCA 21 is the constitutional component of the Governor's Strategic Growth Plan (SGP) that would establish a 6 percent cap on the amount the state could spend for infrastructure debt service relative to General Fund revenue.

   The overall bond plan by the Governor includes $68 billion in General Obligation bonds over five-election cycles (or ten years). Totals, by subject matter, are as follows: (1) transportation -- $12 billion; (2) K-12 education -- $26.3 billion; (3) higher education -- $11.7 billion; (4) flood control and water supply -- $9 billion; (5) public safety -- $6.8 billion; and (6) courts and others -- $2.2 billion.

7) ***Potential Cost of Administration's Package***. According to the DOF, assuming $68 billion in General Obligation bonds as contemplated by the administration's SGP, the State will incur ***additional*** General Fund debt service costs, above debt service on currently authorized bonds, beginning in 2007-08 of $75 million, growing to $4.7 billion by 2025-26.

   The administration assumes, beginning in 2010, that resources devoted to paying off the Economic Recovery Bonds (ERBs) will be shifted to repay principal and interest on its SGP – this level of funding is estimated to be $1.7 billion in 2010; growing to $3.6 billion by 2025. The Legislature, if approving the general assumptions inherent in the SGP, would be making an expenditure decision that will continue for many years into the future. The potential use of "freed-up" ERB debt repayment resources would be decided in a vacuum of information about other future General Fund expenditures or legislative priorities, thereby "crowding out" future non-bond related expenditures.

Support:
None on file.

Opposition:
None on file.